

Is the World Returning to 1970s Stagflation?

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The current fear of most economists is that Britain and the major OECD economies are headed for 1970s-style stagflation, a bleak combination of low growth and high inflation. But, of these two evils, they proclaim inflation to be the worst. Fix inflation and growth will follow is the common current mantra, especially of the Bank of England and the European Central Bank. This view is not only wrong but also deeply dangerous.

The 1970s ushered in the 'monetarists' revolt against Keynesianism, based, in part, on the fear of hyperinflation. But two points are crucial about inflation in the OECD countries in the 1970s and now.

First, no OECD country experienced anything approaching runaway inflation. While many large European economies went from single digit to double digit inflation for some years, inflation at its height reached only 25 per cent in Britain (1975), only 19 per cent in Italy (1977), only 14 per cent in France (1974) and in no year reached even 10 per cent in Germany (see Table).

Year	US	France	Germany	Italy	UK
1971	4.4	5.6	5.1	4.8	9.2
1972	3.2	6.3	5.6	6.2	7.1
1973	6.2	7.1	7.0	10.2	9.4
1974	11.0	13.9	7.0	19.4	15.8
1975	9.1	11.7	6.0	17.1	24.5
1976	5.8	9.6	4.2	16.7	16.4
1977	6.5	9.6	3.6	19.3	15.8
1978	7.6	9.1	2.7	12.5	8.3
1979	11.3	0.6	4.2	15.5	13.5

Source: Irvin (2008:68)

Secondly, today's inflation is mainly imported through higher fuel and food prices. In the 1970s, the main OECD economies had stronger industrial sectors and better organised workers than is the case today, so imported inflation could turn into wage-push domestic inflation.

Today the structural features facilitating double digit inflation 30 years ago have all but disappeared. In Britain, for example, the share of manufacturing in GDP has fallen from above 40 per cent in the 1970s to about 13 per cent today, while trade union membership has fallen from 13 to 7 million. More and more workers are employed in the low-wage service sector, or else are part-time or self-employed.

Who loses from mild inflation?

Headline inflation (which includes food and other fluctuating prices) is currently running at around 3.5-4.0 per cent in the large industrialised countries. This is no higher than the average for the post-war boom years.

So why are many economists worried if inflation is more than two per cent per year? The answer is that it hurts the financial sector. Bankers lose because the mortgages and other fixed-interest securities that they hold as assets lose their real value (see Irvin 2008).

In contrast, mild inflation (as opposed to double digit inflation) favours the majority of citizens. These include households who hold mortgages and many small businessmen who are in debt to banks. As long as government and the trade unions pursue a wages policy designed to prevent real wage erosion, mild inflation need not harm working class families. But because mild inflation erodes financial sector profits—and the financial sector has become increasingly important and politically vocal in the advanced economies—it is decried as the chief enemy.

Deflation: the real danger

Why is such monetarist orthodoxy positively dangerous in today's climate? The US housing market has gone into freefall, financial market turbulence is rife and aggregate demand is contracting. A US recession is imminent, and could be prolonged.

Moreover, the credit crunch has caused recession to spill over into Europe, whose core countries experienced zero or negative growth in the second quarter of 2008. In Britain, recession is expected in late 2008.

During the mild recession of 2001, the US was running a budgetary surplus and thus could afford to loosen the fiscal reins. Today, however, the room for fiscal manoeuvre is far more limited. For example, at the member-state level, the Eurozone continues to call for fiscal restraint while at the supranational level, it has torpedoed a counter-cyclical fiscal policy by insisting that the annual budget be balanced.

Hence, the danger for the OECD countries is not so much inflation as deflation, namely, falling prices along with declining incomes. Deflation was last experienced on a large scale in the USA and Europe in the 1930s. In Japan after 1989, when the property bubble burst, incoherent economic policies virtually paralysed the economy, resulting in falling prices during much of the 1990s.

The OECD's latest projections suggest that the increases in food and fuel price rises will slow considerably in 2009, bringing overall inflation back below two per cent. If the rest of Europe exhibits macroeconomic trends similar to those in the US and Britain, the resulting recession could be longer and deeper than forecast.

So the worst possible scenario for the world economy now is that excessive anti-inflationary zeal in the OECD will lead to Japanese-style deflation for the foreseeable future, namely, a falling price level along with negative growth.

Reference:

George Irvin (2008). *Super Rich: the Growth of Inequality in Britain and the United States*. Cambridge: Polity Press.